Canaries in the Coalmine: The Year Ahead in Capital – Outtakes from Miami

Being in Miami the last week of January can mean a lot of things. You were at Context, the world's largest Cap Intro conference. Or perhaps you were attending the Managed Funds Association (MFA) annual conference. In 2020, it also could've meant you were really excited for the Super Bowl and wanted to get down there early with your Patrick Mahomes shirt.

Every year, Jefferies spends a week putting their ear to the ground with stakeholders across these events – talking to hundreds of managers, allocators, counterparties and service providers to get a sense of what may lie ahead. This year, we're reporting on general sentiment and trends – but also some of the highlights from our "canaries in the coalmine."

Everyone has their own canaries in the coalmine – clients, partners or counterparties who just seem to have a finger on the pulse more than others. Those who have an eerie predictive power. Here are some of our highlights as well as some of what we heard from our smartest, most forward thinking, most sophisticated contacts.

IN 2020, THINGS WERE…MUTED

Maybe it's the Coronavirus. But after an +30% year for equities and coming off of the best year for hedge funds in a decade, you would've expected slightly more exuberance. Or at least confidence and excitement about the decade ahead. The closest we got to that was the enthusiasm for Snoop and Cardi B at the Fontainebleau. Managers, allocators and nearly everyone we spoke to was more cautious than optimistic. These people are paid to be stewards of others' capital for a living, so perhaps that sentiment makes sense, but overall it was a much more muted week in terms of expectations for the year ahead.

MARKET STRUCTURE AND PERSISTENTLY LOW NUMBERS OF U.S. PUBLICLY TRADED COMPANIES IS AN ISSUE

The last time the U.S. experienced this longstanding an expansion, we had *twice* the number of publicly traded companies we do now. Couple this with the number of investors remaining near all time highs means more players in a smaller sandbox. This has massive implications for crowding, performance and whether this up market will continue. More than one of our most sophisticated and successful investors across cycles mentioned these dynamics as something they are closely watching for 2020 and beyond.

MONEY IS STILL FLOWING, BUT NOT NECESSARILY TO THE PLACES YOU'D EXPECT

The industry witnessed ~$40 billion in net outflows in 2019, but our smartest allocators kept bringing up two (completely different) but consistent themes:

a. **Sustainability**. Yes, it's a buzzword. But yes, *a lot* of people increasingly care about it in some way, shape or form. And they don't all care about it in the same way. Some allocators are passionate about understanding their carbon exposure across the portfolio. Others are leaning into ESG reporting broadly, or understanding what their own managers are doing about running more responsible, sustainable operations.

b. **Off the run investments** – co-invests, SPVs and niche strategies were in high demand. High pedigreed managers will always be in focus – call them the Ferragamo of alternative investments. But for everyone else, the most sophisticated allocators are looking for places to put their money that might not have crossed their desk a decade ago.

TARGET RETURNS Whether it's a family office with underlying family needs or an endowment that has to fund programs or foundations with grant writing needs, people are searching for yield and performance - and they don't know where to get it. Bottom line, the 5 percent plus inflation is hard to hit these days (and it's feeling more like 9 percent real) across the portfolio and hedge funds haven't been helpful getting them there (at least traditionally speaking). As such, this has led to either folks looking at these niche and uncorrelated hedge fund structures or the long only liquid equity route that can swing for the park. Structurally, it feels like hedge funds are perhaps being less used as a traditional absolute return or vol dampener right now.

THERE'S A HUNGER FOR INNOVATION

The hedge fund industry is quite mature, and while innovation is happening at a fund level, a number of managers and allocators mentioned we've missed the innovation that's happened in the passive world (if you can call it that). If the 1990s and early Aughts belonged to funds, there is a hunger for the visionary risk taker willing to make new bets in new strategies. Whether cash will flow remains to be seen but we heard this from a variety of thought leaders.

STUCK IN THE MIDDLE WITH YOU

Not a great time be directional in this market and take on additional beta risk given macro backdrop and frothy market valuations. Investors seem to be more interested in relative value or market neutral managers.

UP MARKETS. ZERO RATES. CHINA GOING OFFLINE FOR A WHILE – not a combination setting us up for a blockbuster Q1. SARS saw the market sell off materially and Coronavirus is more contagious. The world's second largest economy is effectively quarantined, and while we were happy one of our colleagues just had "run-of-the-mill flu," in the know healthcare and Asia experts both expressed concern and curiosity for how this resolves.

LICENSE TO ILL(IQUIDITY)

There is still high interest in private equity or private credit from both families and institutions largely because investors feel that risk/returns are still attractive vs other asset classes. Additionally, the 'lower for longer' environment is forcing institutions to continue to search for returns/yield in the private markets.

Groups who are experienced private equity investors seemed to be more focused on looking at re-ups with their current roster and less interested in new funds. Groups who are newer to the asset class seem to be more focused on mid-market buyout and growth capital funds. Strong emphasis on funds that can create value/returns via operational improvements. In terms of single sectors, healthcare and tech came up more often.

Certain areas are perceived to be getting crowded (e.g.: specialty finance) - with too many new entrants resulting in compressed yields. As such, interest seems to be less U.S. focused and more on less crowded/less efficient markets like Asia.

Biggest fears regarding the private equity market are:

- Too much money is chasing too few opportunities (across all areas of private equity)
- Top of the cycle
- Like the rent, valuations/multiples are too high
- The above is true…and your money is locked!

What Lies Ahead? Predictions for 2020

1. Nothing is for sure. Global growth. Impact of Coronavirus. What happens next with Brexit. The U.S. Presidential election. Perhaps the flip side of the muted energy in January will be markets shrugging off events that in prior years would have been material to performance. Then again…maybe not.
2. Where's my yield/return/alpha? Families, individuals and institutions are all wrestling with how to turn their assets into *more assets* – and the risk/reward profiles out there are leaving investors across the spectrum wanting. Never have we heard so much about niche and off the run investment opportunities as last week.
3. New decade. Same industry. New partners? There is a certain maturity and institutionalization that has happened for alternatives – but with a few proposed SEC changes, it's possible that small regulatory tweaks could open doors to new partners for the coming decade.

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